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TREASURY FOR DEPUTY SECRETARY KIMMITT, ALSO FOR
DO/W.LINDQUIST; STATE FOR EEB/IFD/OMA, EEB/ESC, AND EUR/WE

E.O. 12958: DECL: 03/05/2013

TAGS: [ECON](#) [EFIN](#) [KTFN](#) [IR](#) [SP](#)

SUBJECT: TREASURY DEPUTY SECRETARY KIMMITT'S MEETING WITH
CENTRAL BANK DEPUTY GOVERNOR VINALS

REF: STATE 21770

Classified By: DCM Hugo Llorens for Reasons 1.5(b) and (d)

11. (C) Summary: On March 5, visiting Deputy Treasury
Secretary Kimmitt, accompanied by DCM, discussed with Bank of

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Spain (central bank) Deputy Governor Jose Vinals the U.S. and Spanish economic situations, sovereign wealth funds, and Iran. The Deputy Secretary said that the U.S. economy was expected to continue growing and not enter a recession, though growth was slowing. Vinals expected Spanish growth rates to gradually decline during 2008, with full-year growth of between 2.5 and 2.7 percent. He was less concerned about Spain's housing and real estate slowdown than about the drying up of international credit markets, saying that if the current situation continued through 2008 and well into 2009, Spain - and many other countries - would face serious trouble. He also expressed concern about what he termed misleading British press reports about the Spanish economy. The Deputy Secretary emphasized the importance of close scrutiny of Iranian banks and noted his concern that two Spanish banks maintained correspondent banking relationships with Iranian banks, including one cited in UNSCR 1803 as warranting particular vigilance. Vinals promised to investigate, and on March 7, his office sent us information obtained from the two banks. Post is analyzing that information and will report it septel. End Summary.

U.S. and Global Economic Situations

12. (C) The Deputy Secretary began by reviewing the state of the U.S. economy. The Treasury and most economists expected the economy to continue to grow and not enter a recession, although growth was slowing. He explained the consumer and business components of the recently enacted stimulus package, saying that its impact would begin to be felt in the second quarter. He noted that the job creation effects of the business component were especially important, as employment had declined in January, the first decline after a record 51 consecutive months of growth. The economy was facing three headwinds - the housing crisis, the credit crunch, and high commodity/natural resource prices. By the end of the year, he expected the economy to return to its trend growth rate. The next few quarters would be difficult, though. He outlined the Administration's efforts to keep homeowners, especially first-time homeowners, in their homes through the HOPE NOW program of voluntary mortgage revisions. He noted two reports coming out in the next month, one from the President's Working Group on Financial Markets and the other a blueprint for regulatory reform for bank supervision, that would help address regulatory problems that had been revealed by recent developments. He said the budget deficit would

grow from its 2007 figure of 1.2 percent of GDP, in part because of the stimulus package, but would stay below 3 percent in 2008. For the medium term, he noted the importance of promoting growth, including making the Administration's tax cuts permanent, addressing entitlements, and encouraging savings as relevant to the Administration's goal of achieving a balanced budget in 2012.

13. (C) Vinals expressed confidence in the USG's judgment and ability to decide on the appropriate actions. He agreed that it was important to prevent future crises but also emphasized Spain's concern about the present one. He said financial capital was being "renationalized" as international credit markets were drying up. He expressed concern that if trends continued, a global credit crunch could result. He acknowledged the importance of transparency but said other measures would be necessary to restart global markets. He called for a global solution and for countries' domestic solutions to be consistent. He said it looked like the problem had been spreading since July, with different markets being affected in turn, including stocks, banks, monolines, exchange rates, with commercial property and other markets of securitized assets possibly to follow. He welcomed U.S. initiatives to stabilize the housing market but noted that it might take a long time for confidence to return. He expressed relief that the U.S. economy had been resilient and that emerging markets were "holding on." He said Spain could take some actions to address its problems but that if global markets deteriorated significantly, Spain could only hope to limit the damage. In discussing Spain's concerns, Vinals noted that Spain was not in the G7 but would like to be one day; the Deputy Secretary acknowledged Spain's longstanding interest in G-7 membership and its important role in the ECB and the BIS. He also noted that we were lucky that the world economic growth environment was the best in the last 30 years.

Sovereign Wealth Funds

14. (C) The Deputy Secretary said U.S. banks were acknowledging their problems and were strengthening their balance sheets by adding capital. One important source of capital was sovereign wealth funds (SWFs). He explained that most SWFs were passive investors, for example, not seeking board seats, seeking to diversify their assets without causing political controversy. The USG had encouraged a process led by the IMF on best practices by SWFs and hoped to keep support from the public and Congress despite what appeared to be rising "investment protectionism."

Spanish Economic Situation

15. (C) Vinals reviewed Spain's economic history, saying that over the past 24 years growth had averaged nearly 3.5 percent. The only interruption had been a short but deep recession in 1992-93. 2007 growth had been higher than trend, at 3.8 percent, but growth had decelerated steadily since the summer. The Bank had long expected an adjustment in 2008-09 as the result of the end of the decade-long housing boom, but it had not expected the external pressure that began to be felt in August. He expected 2008 growth to be 2.7 or 2.8 percent, with the risk on the down side. He then said, not for attribution, that even 2.5 or 2.6 percent would not be bad. He expected the deceleration through 2008 to be gradual, with year-on-year fourth quarter 2008 growth of 2.4 percent. He hoped the government that took office after the March 9 elections would take only temporary stimulus measures, and he noted the GOS's healthy 2007 budget surplus of 2 percent of GDP. The banking sector was in good shape; bank profits were up 27 percent last year, and bank provisions were very high, around 2.5 percent of doubtful loans. The Bank had run stress tests and was confident that the banking system could survive any negative surprises in 2008. He was not as concerned about the housing sector as about the lack of international credit. He added that if international markets remained "closed" through 2008 and much of 2009, many banking systems around the world would have serious trouble, and Spain would be no exception. On the

other hand, if the international difficulties could be resolved, Spain's housing and real estate adjustment would be manageable.

¶16. (C) Vinals expressed frustration that international markets were not distinguishing between what he said was Spanish paper with high underlying asset quality and that of other countries. He later said that "the British press" had been giving Spain's construction slowdown a lot of attention and were saying that had Spain not been a Euro member, its banks "would have been big Northern Rocks." He said commentators were confusing Spanish banks' going to the ECB to build up reserves with going to the ECB because nobody else would lend to them. (Comment: By the British press he mainly meant the Financial Times, whose coverage has attracted criticism from the Spanish banking association and others. In the March 3 presidential debate, opposition candidate Mariano Rajoy quoted from a pessimistic FT op-ed.)

Iran

¶17. (C) The Deputy Secretary emphasized the importance of keeping financial systems safe from abuse by terrorists, proliferators, drug dealers, criminals, and other illicit actors, such as Iran. He said cooperation with Spain was good. He noted the three Security Council resolutions on Iran and that the Financial Action Task Force had reported that Iran was lacking an anti-money laundering regime. He described UNSCR 1803's call (reftel) for authorities to exercise particular vigilance over activities of Iranian financial institutions, especially Banks Melli and Saderat. Bank Director General of Banking Supervision Javier Ariztegui said that as far as the Bank knew, the situation with respect to Iran was fully under control. Vinals added that fighting terrorism and money laundering was a top priority of the Bank and of GOS authorities. The Deputy Secretary noted that as the UK, France, and Germany cracked down on Iranian activities, Iran was moving to Switzerland, Austria, and Italy. There was no evidence that they were moving to Spain, but vigilance was important.

¶18. (C) The Deputy Secretary noted that two Spanish banks, Santander and Sabadell, had correspondent relationships with Iranian banks. Santander had a relationship with Melli, which had been cited in UNSCR 1803. He noted that the banks would need to be careful carrying out even routine transactions given Iran's history of using routine transactions to conceal illicit ones. He also noted that

Santander was expanding in the U.S. and that we would not want it to be the subject of reputational harm because of links to Iran. He said we would like to see the two Spanish banks' relationships with Iran ended and that we would not want to see Spanish banks being unwittingly involved in illicit transactions. Vinals promised to check on the two banks' relationships with Iranian entities.

¶19. (C) Comment: At a lunch hosted by the Ambassador the following day, the Deputy Secretary spoke privately with the president of Sabadell, who indicated that the Bank of Spain had spoken with his bank that morning. He appeared responsive to USG concerns and requested more information. On March 7, the Central Bank sent post information it had obtained from the two banks. Post is analyzing that information and will report septel. End Comment.

¶10. (U) Deputy Secretary Kimmitt has cleared this cable.
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